

**Statement of Rayola Dougher, Manager, Energy Markets,
on behalf of the American Petroleum Institute before the
House Government Reform Subcommittee on Energy and Resources**

May 9, 2005

Mr. Chairman, I am Rayola Dougher, manager, energy markets, for the American Petroleum Institute, which is the national trade association for the U.S. oil and natural gas industry. API represents all sectors of the industry, including companies that make and market gasoline.

API welcomes this opportunity to discuss why gasoline prices are so high and what can be done about it. Obviously, your constituents, like Americans everywhere, are concerned about the continuing rise in prices, and the impacts on their wallets and on the U.S. economy.

I believe America's oil and natural gas industry shares common values and concerns with you:

- We share your commitment to finding workable solutions to our nation's energy problems;
- We are committed to providing consumers with reliable energy supplies;
- We work hard to support economic growth;

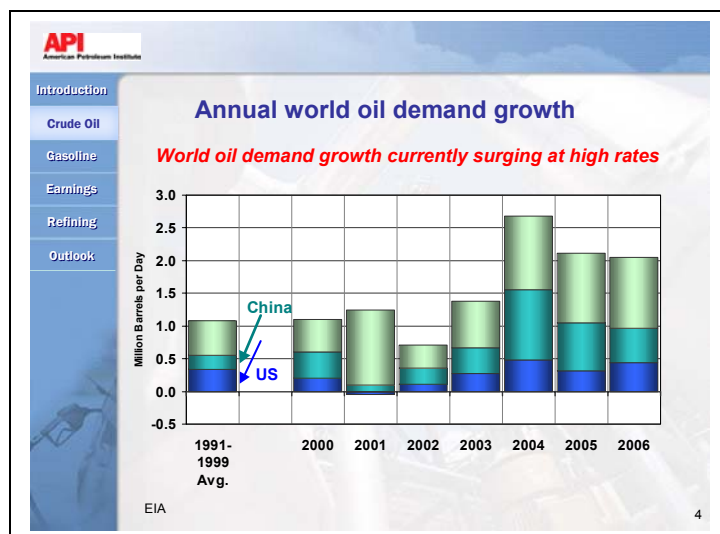
- We believe our domestic oil and natural gas resources can be developed in a responsible way -- technological advances enable us to produce energy while protecting the land and the environment; and
- We want to work with you in building support in Congress for urgently needed comprehensive energy legislation.

Why Have Gasoline Prices Risen?

The price of gasoline has risen in California, as it has across the nation, primarily because U.S. refiners are paying more for crude oil, the principal cost component of a gallon of gasoline.

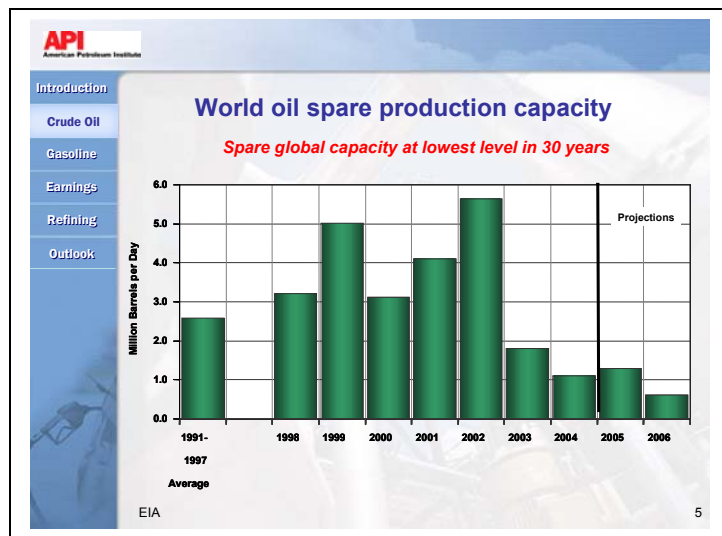
Over the past year, crude oil has risen more than \$18 per barrel, the equivalent of more than 42 cents per gallon. However, the crude price remains well short of the inflation-adjusted high of \$80 per barrel in 1981.

Prices are rising because of the forces of supply and demand in the global crude oil market. Supply and demand is in a razor-thin balance in the global market. Small changes in this market have a big impact.



World oil demand continues to grow. Demand reached unprecedented levels in 2004. Strong economic growth, particularly in China and the United States, is fueling a surge in oil demand. The U.S. Energy Information Administration (EIA) reports that global oil demand in 2004 grew by 3.4 percent – the strongest growth since 1978 – and projects growth to increase by about 2.6 percent this year and next. By comparison, world demand between 1993 and 2003 grew at an average rate of 1.6 percent.

At the same time, world oil spare production capacity -- crude that can be brought online quickly during a supply emergency or during surges in demand -- is at its lowest level in 30 years. Current spare capacity is equal to about 1



percent of world demand. EIA projects spare capacity for 2005 at just over 1.0 million barrels a day. Thus, the world's oil production has lagged, forcing suppliers to struggle to keep up with the strong growth of demand.

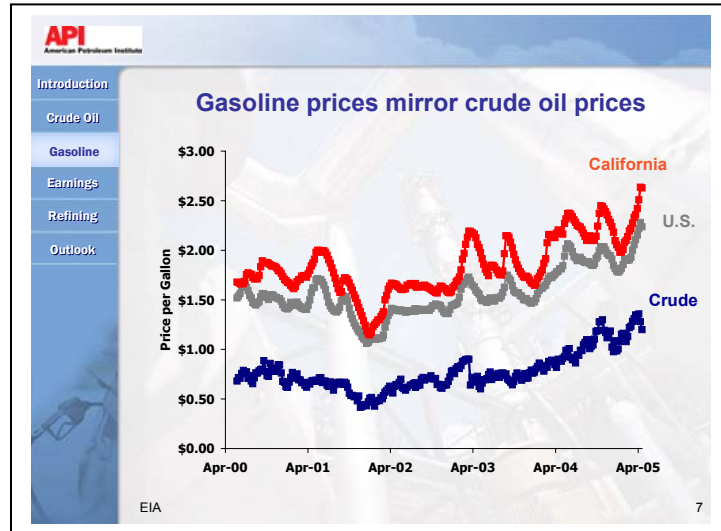
The delicate supply/demand balance in the global crude oil market makes this market extremely sensitive to political and economic uncertainty, unusual weather conditions, and other factors. Over the past year, we have seen how the market has reacted to such diverse developments as dollar depreciation, an unusually cold winter, the post-war

insurgency in Iraq, the continued impact on the Venezuelan sector from the oil workers' strike in 2002-03, ongoing ethnic and civil strife in Nigeria's key oil producing region, and decisions by OPEC.

Gasoline Prices Mirror Crude Oil Prices

While consumer concern about high gasoline prices is very understandable, we must recognize that gasoline prices mirror crude oil prices. Crude oil costs make up more than 50 percent of the cost of gasoline.

Retail gasoline prices and crude

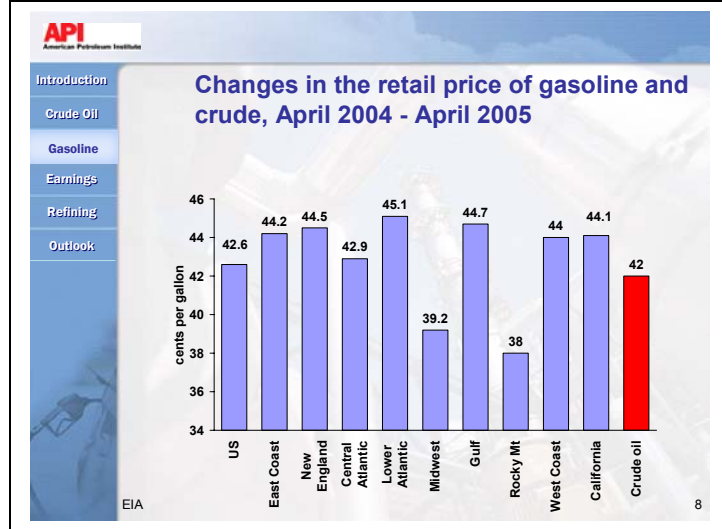


oil prices have historically tracked, rising and falling together. We import more than 60 percent of the crude oil and petroleum products we consume. American refiners pay the world price for crude and distributors pay the world price for imported petroleum products. U.S. oil companies don't set crude oil prices. The world market does.

Whether a barrel is produced in Texas or Saudi Arabia, it is sold on the world market, which is comprised of hundreds of thousands of buyers and sellers of crude oil from around the world.

Gasoline Prices: California and U.S.

As crude prices rise, so, too, do prices at the pump. Gasoline prices have risen 42.6 cents per gallon over the past year, averaging \$ 2.28 as of April 25. Here in California, the impact has been just as severe, with prices rising 44.1 cents since last April, averaging \$ 2.61 as of April 25.



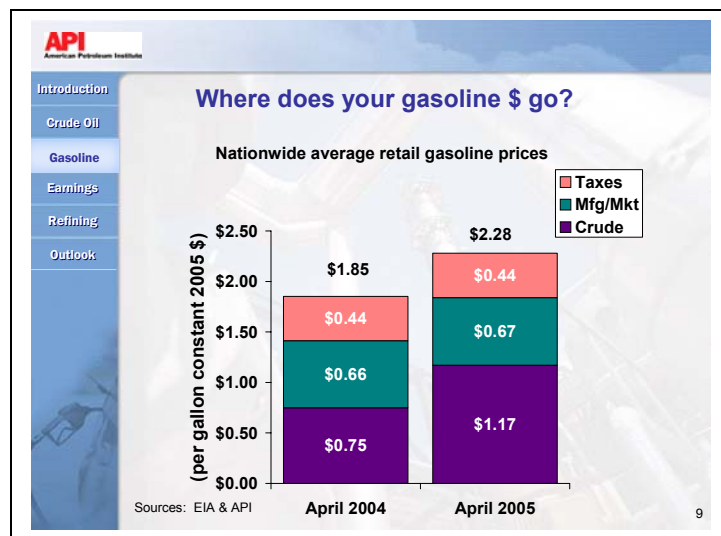
Meanwhile, U.S. gasoline demand continues to grow along with the U.S. economy, showing a moderate 1.3 percent increase over the level of a year ago. Gasoline production is running at record levels, averaging 1.2 percent above last year. Inventories have built up in recent weeks and are 5.5 percent above average for this time of year. U.S. refineries are operating at 92.3 percent of capacity.

Gasoline prices here in California are higher than elsewhere in the country because taxes are higher—about 13 cents per gallon more than the average for the rest of the nation—and because of the unique aspects of the state’s gasoline market. That market was well described at the American Bar Association’s 2005 spring meeting by Margaret E. Spencer, senior Deputy with the Antitrust Section of the California Attorney General’s Office:

“The state of California is an ‘island,’ with its own boutique fuel and few sources of outside supply. It is an island with a petroleum infrastructure that at all levels is stretched to the breaking point. Its refineries are fewer than they were, and producing at capacity to respond to an ever increasing demand. Its refined product pipelines are full. Its storage terminals are full. Its marine docks are operating near or at maximum capacity. Local political pressure is eliminating critical marine and storage facilities to make room for container storage, parks, and ‘windows to the water.’ The end result is that when a single refiner or pipeline operator suffers a disruption, it can be difficult to make up the slack in the short term.” (Margaret E. Spencer, “Increasing Gas Prices: A California Perspective,” March 2005)

California gasoline supply has struggled to keep up with gasoline demand even though gasoline production is at record levels, averaging 3.4 percent above average so far this year. West coast inventories are 0.7 percent below average for this time of year, but 12.5 percent above where they were a year ago.

Despite the tight market in California for refined products, the most significant shift here and across the country in the price of gasoline is due to the change in the price of crude. When the price of crude oil is \$49 per barrel, as it was recently,

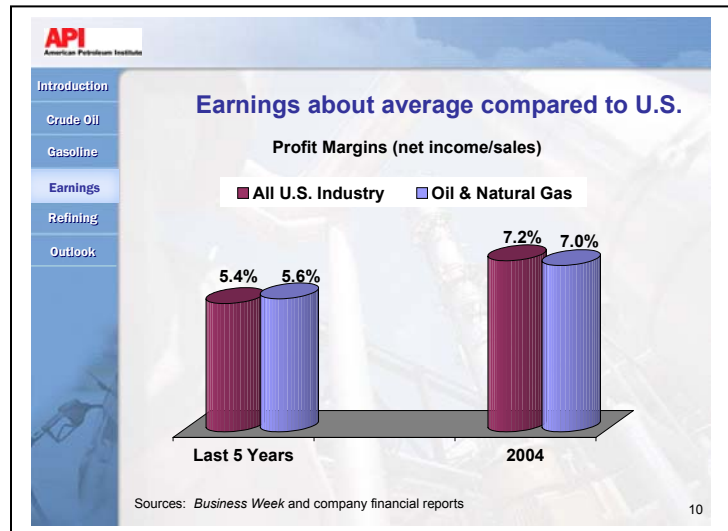


a refiner paid about \$1.17 cents for a gallon of crude oil in order to make a single gallon of gasoline. A year ago, it was just 75 cents a gallon. In addition, other costs affect the pump price, including the cost of running refineries, transporting the finished gasoline to

markets via pipelines and trucks, and operating retail outlets. These costs account for about 67 cents per gallon of the price at the pump nationwide, or a penny more than last year. In addition, there are taxes, 44 cents per gallon nationwide.

Earnings

There is a lot of misunderstanding about the oil and natural gas industry's earnings and how they compare with other industries. The oil and natural gas industry is probably the world's largest industry. Its revenues are large, but so are its costs, both the cost of

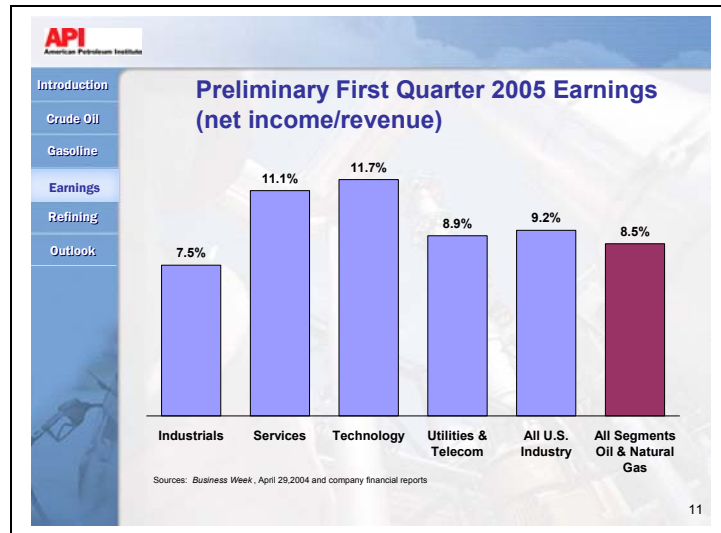


finding and producing oil and natural gas and the costs of refining, distributing and marketing it. Oil companies are making billions of dollars in earnings, but they are spending trillions bringing crude oil and petroleum products to market.

The industry's profitability is not out of line with other industries and often it is lower. This fact is not well understood, in part, because reports typically focus on only half the story—the profits earned. Profits reflect the size of an industry, but they're not necessarily a good reflection of financial performance. Profit margins (measured as net income divided by sales) provide a better measure of a company or an industry's health,

and also provide a useful way of comparing financial performance between industries large and small.

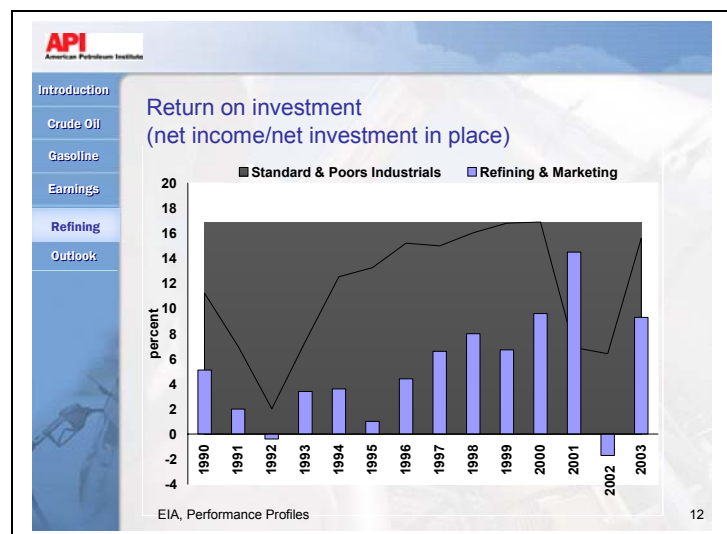
The latest preliminary data for the first quarter of 2005 shows the profit margins of the oil and natural gas industry averaged 8.5 percent compared to an average of 9.2 percent reported by *Business Week* for other major sectors of U.S. industry.¹ Last



year the oil and natural gas industry realized earnings of 7 percent compared to an average of 7.2 percent for all U.S. industry. Over the last five years, the oil and natural gas industry's profit margin averaged 5.6 percent compared to an average for all U.S. industry of 5.4 percent, or just over a nickel for every dollar of sales.

Refineries

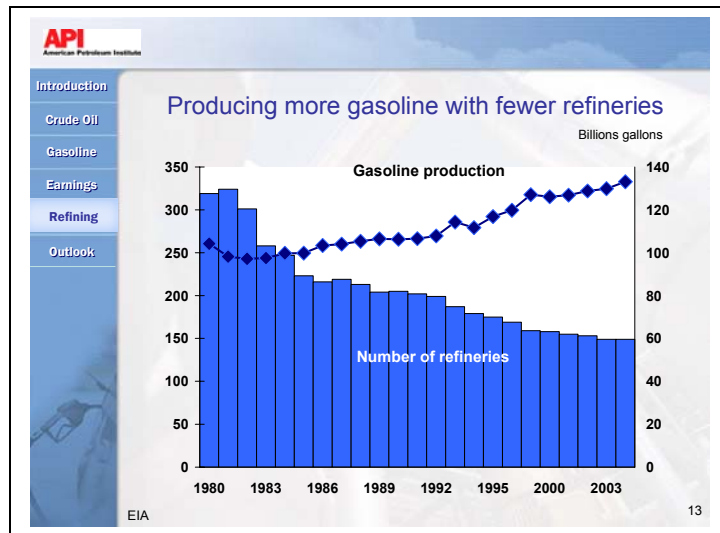
During the 1990s, the oil industry earned relatively poor rates of return on their investments. This was especially true in the refining sector, which was hard hit with the need for



¹ "Flash Report," *Business Week*, April 28, 2005. Includes Industrials, Services, Technology, Utilities & Telecom.

new investment in technology and equipment to produce cleaner burning fuels to meet clean air standards set by the Clean Air Act of 1990. The act had a major impact on the operation of refineries in the U.S. and the return on investment realized at the time.

Technological advancements have helped refineries produce more from existing facilities than they did in the past. In addition, the elimination of subsidies under the government price and allocation controls in 1981 led to the closure of many smaller,



less-efficient refineries throughout the 1980s and 1990s. Those refineries left standing did a better job of bringing product to market for less. This consolidation benefited consumers. We can see this in the decline in the refiner/market margin (measured as the difference between the retail price of gasoline minus taxes and minus the refiner's composite crude oil price). Back in 1980, the cost to refine and market and distribute gasoline averaged about 95 cents per gallon (in inflation-adjusted terms). By 1990, it averaged over 61 cents per gallon, and, by 2000, it was 52 cents per gallon, which is about where it has averaged over the last five years. Multiplying these reductions by the 330 billion gallons of petroleum products consumed translates into billions of dollars of savings for consumers. We all benefit every day from these improvements and efficiency gains.

Outlook

Energy analysts generally agree that the near-term market outlook is for continuing strong world oil demand, with limited spare capacity to meet growing demand. The political and economic concerns remain, contributing to continued volatility and uncertainty in the global market. However, as the forces of supply and demand respond to price, the market should adjust accordingly.

We understand the frustration of consumers with high gasoline prices. The price increases have generated calls for investigations. However, some 30 different state and federal government investigations over several decades have found no evidence of wrongdoing. They all conclude that market forces of supply and demand are at work.

What Can Be Done?

The solution to high gasoline prices is more supply of crude oil and gasoline and less demand, but there is no simple strategy to make that happen.

The sad fact is that the current approach to national energy policy has failed U.S. consumers. The net effect of current oil and natural gas policy is to decrease reliance on domestic production and increase dependence on foreign imports. Moreover, while crude oil imports have been growing for some time, product imports are also growing rapidly due to constraints on U.S. refining capacity.

The problems we face are very real. Growing world demand for energy, failure to enact energy legislation, and a lack of commitment to developing our domestic resources have resulted in a tight supply/demand balance for U.S. consumers, including industrial users. This has led to recurring price spikes, greater market volatility, and overall strain on the nation's energy infrastructure. The big losers are America's consumers who depend so heavily on affordable, available energy to heat and cool their homes, fuel their vehicles, and power their businesses.

While we must focus on producing more energy here at home, we do not have the luxury of ignoring the global energy situation. In the world of energy, the U.S. operates in a global marketplace. What others do in that market matters greatly.

For the U.S. to secure energy for our economy, government policies must create a level playing field for U.S. companies to ensure international supply competitiveness. With the net effect of current U.S. policy serving to decrease U.S. oil and gas production and increase our reliance on imports, this international competitiveness point is vital. In fact, it is a matter of national security.

Meeting Future U.S. Energy Demand

Today's soaring energy prices are an outgrowth of years of restrictive government policies that have rendered it increasingly more difficult to find, produce, and process the U.S. energy reserves needed to keep pace with our nation's growing economy. We cannot

solve a problem that has been years in the making with less than comprehensive answers and remedies.

This comprehensive approach must include additional exploration, development and production of fossil fuels; additional increases in energy efficiency, such as greater use of hybrid vehicles; and increased research and development related to alternative fuels, such as tar sands, shale, renewable fuels, hydrogen, and methane hydrates.

Our already massive U.S. energy needs will continue to grow as we move into the 21st century. We do not have the luxury of focusing on just one source of energy and neglecting others. What is needed is a comprehensive effort to produce more domestic energy of all kinds, modernizing and expanding our energy infrastructure, and increasing our reliance on energy efficiency and alternative fuels.

In an industry with huge capital demands and where long lead-time investments are necessary in order to increase volumes of delivered products, short-term fixes are not the answer. Nor is inaction, which burdens consumers and producers, as well as those seeking increased energy efficiency and expanded use of renewable and alternative fuels. Only comprehensive solutions are capable of addressing the long-term supply and demand imbalances that threaten America's security and economic prosperity.

API and its member companies are committed to working with the Congress to achieve passage of comprehensive energy legislation that provides long-term solutions to our

energy challenges. Our industry has a long, proud history of meeting the needs of consumers, your constituents, but we cannot solve the nation's energy problems alone. That is why we are delighted that the House of Representatives passed H.R. 6, the comprehensive energy legislation that we strongly support. We hope the Senate will act expeditiously on this urgently needed legislation.

While the energy legislation is no short-term remedy to high gasoline prices, it is a major step forward in addressing the energy problems that have contributed heavily to high prices. Had we enacted such legislation four years ago – when President Bush first proposed it – our nation would be in a much stronger energy position today.

Enactment of this legislation will ensure diversity in energy supplies; promote energy efficiency, new technologies, conservation, and environmentally responsible production; modernize America's energy infrastructure; strengthen our economy; and create new jobs.

Such legislation will also address three vitally important energy policy areas: refinery capacity, fuels policy issues and boutique fuels.

Refinery Capacity

The expansion of refinery capacity must be a national priority. The recent gasoline price increases, while primarily caused by increased crude oil prices, have underscored the fact that U.S. demand for petroleum products has been growing faster than – and now exceeds

– domestic refining capacity. While refiners have increased the efficiency, utilization and capacity of existing refineries, these efforts have not enabled the refining industry to keep up with growing demand. Even with a projected expansion of product imports of 90 percent, the Energy Information Administration (EIA) forecasts a need for 5.5 million barrels a day of additional refinery capacity by 2025 beyond today's 16.9 million barrels a day of capacity, even with higher utilization rates.

The fact is that -- faced with increasingly more challenging fuels regulations -- only major refineries have the resources needed to expand their capacity. Smaller refineries are increasingly unable to afford to expand. Moreover, local opposition and not in my backyard (NIMBY) attitudes persist here, too, and prevent new refineries from being constructed. The steady growth in U.S. fuels demand must increasingly be met by foreign product imports. Thus, in addition to blocking or delaying refinery expansion, the extensive federal regulatory burden is contributing to increased reliance on foreign product imports. This is a result that neither serves the best interests of U.S. consumers nor bolsters the U.S. economy and American jobs.

Government policies are needed to create a climate conducive to investments to expand refining capacity. The President's innovative proposal to build new refineries on closed military bases deserves serious consideration. The refining situation must be addressed now. The federal government should act as a facilitator for coordinating and ensuring the timely review of federal, state and local permits to expand capacity at existing refineries and possibly even build a new refinery. Enactment of the energy bill would be an

important step by encouraging new energy supply and streamlining regulations, leading to greater production and distribution flexibility.

Fuels Policy Issues

API and its members support the fuels title contained in the energy bill passed by the House last month. The fuels title would repeal the federal oxygenate requirement for reformulated gasoline and require a national phase-out of MTBE. It also provides a renewable fuels standard phasing up to 5 billion gallons, with a credit trading program to allow the use of renewable fuels where most feasible and cost-effective.

The fuels provisions are needed to discourage state MTBE bans and other specialty fuel requirements. Individual state requirements can increase the number of fuels required within supply regions, thereby increasing the potential for fuel distribution and supply problems. Twenty states have already enacted uncoordinated MTBE bans, caps, or other limits; and other states are considering them.

API, the National Petrochemical & Refiners Association, fuel marketers, and numerous farm and ethanol interests support these fuels provisions. They offer carefully considered solutions to the fuels problems that have challenged fuel providers and burden energy consumers.

Boutique Fuels

Passage of the comprehensive energy legislation is the best way to address the boutique fuels problem: the increasing number of localized fuels that significantly complicate gasoline distribution, contributing to higher prices and tight supplies. The fuels title of H.R. 6 would repeal the federal reformulated gasoline oxygenate requirement in the Clean Air Act, a major driver of boutique fuels. It would also require that EPA consult with DOE on the supply and distribution impacts of new state requests for specialized fuels. Finally, the bill would require EPA and DOE to conduct a comprehensive study of the impacts of boutique fuels and make recommendations to Congress for addressing them, within 18 months of enactment. Given these significant changes and the benefit of the study recommendations, we urge members of Congress to resist imposition of any additional fuel specification changes outside the context of the national energy legislation.

Conclusion

We recognize the impact that high gasoline prices have on California's families and on families across the country. The most important thing my industry can do in the near term is to make and market as much gasoline as we possibly can and encourage consumers to use it efficiently. We will continue to do both.

The concerns that Californians and Americans nationwide have expressed about soaring gasoline prices highlight the need for action to address the energy challenges confronting

our nation. You and your colleagues in the House have taken a major step forward in passing the comprehensive energy legislation, H.R. 6, and we hope the Senate will act quickly and send a bill to the President. Too much is at stake for our country, our economy, and our place in the world to delay action any longer on this urgent national priority.